

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA



In the Matter of the Appeal of)
)
WHITTIER BUILDING AND LOAN ASSOCIATION)

Appearances:

For Appellant: Leo L. Rosen, Certified
Public Accountant

For Respondent: W. M. Walsh, Assistant Franchise Tax
Commissioner; James J. Arditto,
Franchise Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 35 of the Bank and Corporation Franchise Tax Act (Chapter 13, Statutes of 1929, as amended) from the action of the Franchise Tax Commissioner in overruling the protest of the Whittier Building and Loan Association to a proposed assessment of additional tax in the amount of \$790.85 for the taxable year ended December 31, 1940, and in reassessing the tax in the amount of \$880.50 for that year. Certain adjustments reflected in the assessment are not contested by the Association and the tax has been paid On the portion of the assessment attributable thereto.

In June, 1939, the Appellant foreclosed its mortgage on certain real estate, known to it as Property No. 285, and bid the property in at the foreclosure sale for the amount of the secured obligation. On August 25, 1939, Appellant sold the property for less than the amount of the mortgage indebtedness and claims to have sustained a capital loss from this transaction.

In his final action, the Commissioner regarded the difference between the sales price of the property and the amount for which it was bid in as a bad debt. Inasmuch, however, as the Appellant had claimed and been allowed a deduction for an addition to a reserve for bad debts for the year, he refused to allow a deduction for the bad debt on the basis that, having elected to use the reserve method, the Appellant was not also entitled to deduct the specific debt.

Appellant argues (1) that the loss was a capital loss allowable independently of the deduction for an addition to a bad debt reserve, and (2), even assuming the loss to be a bad debt, it should be allowed in full and not limited to the amount allowed as an addition to the bad debt reserve.

We are of the opinion that the Appellant sustained a loss upon the sale of the property on August 25, 1939, in an amount equal to the difference between the amount bid at the foreclosure sale, plus certain capital adjustments thereto, and the selling

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price of the property. This loss, of course, is deductible in addition to the addition to the reserve for bad debts.

Section 19.23(k)-3 of the United States Treasury Department Regulations 103, relating to a federal statutory provision similar to that of the California Act, contemplates precisely the situation which confronts us. After stating that a bad debt deduction may be allowed where the mortgaged property is lawfully sold "for less than the amount of the debt", the Regulation continues:

"... In addition, if the creditor buys in the mortgaged or pledged property, loss or gain is realized measured by the difference between the amount of those obligations of the debtor which are applied to the purchase or bid price of the property (to the extent that such obligations constitute capital or represent an item the income from which has been returned by him) and the fair market value of the property. The fair market value of the property shall be presumed to be the amount bid in by the taxpayer in the absence of clear and convincing proof to the contrary. If the creditor subsequently sells the property so acquired, the basis for determining gain or loss is the fair market value of the property at the date of acquisition."

The Commissioner of Internal Revenue illustrated the application of this Section of the Regulations in I.T. 3159, 1938-1 CB 188, the following example being set forth:

Mortgage indebtedness	\$10,000
Purchase or bid price of creditor.....	<u>10,000</u>
Amount of bad debt deduction	<u>None</u>
Obligation of debtor applied to bid price . .	\$10,000
Fair market value of property	<u>5,000</u>
Capital loss	<u>\$ 5,000</u>

Under this regulation no gain or loss was sustained upon the foreclosure sale for, since neither party has offered "clear and convincing proof to the contrary," we must assume that the fair market value of the property was "the amount bid in by the taxpayer." Under the last sentence above quoted of the Regulation, however, a loss was sustained by the Appellant upon the subsequent sale of the property, the basis for determining that loss being such fair market value at the date of acquisition by foreclosure.

The validity of the Regulation has been sustained in Nichols v. Commissioner of Internal Revenue, 141 Fed. 2d 870, the Circuit Court of Appeals stating at page 876:

"The Regulation is based upon theory that the mortgagee exchanged the obligations of the debtor and receives the fair market value of the property . . . Under the Regulation the mortgagee receives, on exchange, nothing more than the fair market value of the property foreclosed."

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We conclude, therefore, that the Appellant sustained a loss during the income year 1939 in an amount equal to the difference between the basis of the property, i.e., the fair market value of the property at its date of acquisition (which is presumed to be the amount for which it was bid in at the foreclosure sale) plus certain capital adjustments, and the price for which the property was subsequently sold. Nichols v. Commissioner of Internal Revenue supra; Hadley Falls Trust Co. v. United States, 110 Fed. 2d 887; Helvering v. New President Corporation, 122 Fed. 2d 92.

O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Chapter 13, Statutes of 1929, as amended, that the action of Chas. J. McColgan, Franchise Tax Commissioner, in overruling the protest of Whittier Building and Loan Association to a proposed assessment of additional tax in the amount of \$790.85 for the taxable year ended December 31, 1940, and in reassessing the tax in the amount of \$880.50 for that year, be and the same is hereby modified; the said Commissioner is hereby directed to redetermine said tax through a recomputation of the net income of said Whittier Building and Loan Association on the basis of the allowance of a deduction from the gross income of said Association for the year 1939 of a loss pursuant to Section 8 of the Bank and Corporation Franchise Tax Act in an amount equal to the difference between the amount for which the property known as Property No. 285 was bid in at the foreclosure sale plus appropriate capital adjustments and the price for which the property was subsequently sold; in all other respects the action of the said Commissioner is hereby sustained; provided, however, that credit shall be allowed by the Commissioner for such amounts as have been paid by said Whittier Building and Loan Association in partial satisfaction of said proposed assessment of additional tax,

Done at Oakland, California, this 7th day of January, 1948, by the State Board of Equalization.

Wm. G. Bonelli, Chairman
J. H. Quinn, Member
Jerrold L. Seawell, Member
George R. Reilly, Member

ATTEST: Dixwell L. Pierce, Secretary